CONCLUDING STATEMENT

South Africa: Staff Concluding Statement of the 2021 Article IV Mission

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An International Monetary Fund (IMF) team led by Ana Lucía Coronel held virtual meetings with the economic authorities and other counterparts from the public and private sectors from November 17 to December 7, 2021 for the 2021 Article IV annual consultation. Discussions focused on policy measures and reforms needed to transform the current South African cyclical rebound into a lasting, job-creating, inclusive, and green recovery.

Context and Outlook

The COVID-19 pandemic hit South Africa at a time when its economic vulnerabilities had already been aggravated by a prolonged period of depressed investment, subdued growth, and high and rising public debt. In this context, the country suffered one of the largest output contractions among emerging market economies (EMEs) in 2020. Social conditions, already strained by stubbornly high poverty, unemployment and inequality, worsened further—the education system suffered, and job losses disproportionally affected the youth, women, and the poor. A significant loss of jobs has been recorded, taking the unemployment rate to record high levels.

The authorities reacted swiftly to the pandemic's fallout by providing cash support, unemployment protection, and loan guarantees, as well as ensuring adequate liquidity conditions and facilitating bank loan restructuring. They had to adapt mobility restrictions to evolving COVID-19 variants, including Omicron, which the country's advanced genomic surveillance system identified, and promptly brought to the attention of the international community. While greatly contributing to the global fight against the pandemic, the authorities are now facing the related health challenges and economic repercussions from travel restrictions introduced by other nations. As recently indicated by President Ramaphosa, there is now an urgent need to accelerate vaccination of the population, which will be the most effective way to overcome the pandemic.

The cyclical recovery in 2021 has been relatively strong—staff estimates an output rebound of about 4.6 percent after the 2020 contraction (-6.4 percent)—as the lockdowns were phased out. The recovery was also supported by external factors, such as favorable commodity prices and benign financial conditions, which are likely temporary. More alarmingly, the rebound has not decreased the unemployment rate amid deteriorating confidence (exacerbated by the July social unrest episode), anemic private-sector investment, and weak credit extension. Staff therefore projects a lackluster medium-term outlook, with growth averaging 1.4 percent per annum, inflation returning to the midpoint of the 3–6 percent target range, and the external current account reverting to its structural deficit.

The economy's sources of strength, including anchored inflation expectations, a sophisticated financial system, and a flexible exchange rate can support the necessary growth revival. However, absent decisive action to address obstacles to investment and reduce the government's need to borrow, growth and employment will not pick up. Declining private investment and productivity, which have been a hinderance to economic growth, need to be urgently reversed so that the country can produce goods and services of higher quality at lower costs that can compete in global markets. Greater investment will generate more job opportunities for many South Africans, reducing poverty and inequality. The pandemic has also highlighted the crucial need to put the country's public finances in order to reverse the upward public debt trajectory thus reducing financing costs, increasing market confidence and attracting investment. Improving the quality of public expenditure will make room for investment in infrastructure and basic services for the population and the provision of well-targeted social support.

With the ongoing COVID-19 wave, downside risks to the outlook are more prominent. These include, externally, an extended period of travel restrictions to the region, a sharp drop in the prices of commodities that the country exports, and a sudden tightening of global liquidity conditions. Domestic risks include additional COVID-19 outbreaks (exacerbating already deteriorating health conditions), continued worsening performance of state-owned enterprises (SOEs), delays or reversals in reform implementation, and social instability. On the upside, South Africa's formidable economic potential would sustain strong growth should the necessary reforms and adjustment remove longstanding obstacles to durable economic expansion and poverty reduction.

Reducing Growth Impediments

Structural rigidities are depressing private investment and hindering inclusive growth and job creation. These rigidities need to be tackled immediately to increase the economy's productivity and competitiveness and reduce poverty and inequality. To this end, immediate actions are warranted to:

- **Raise the efficiency of the economy, particularly in network industries.** Essential services, such as electricity, telecommunications, and transportation, are expensive and/or unreliable, contributing to the high cost of doing business. The issue needs to be addressed by enhancing competition in these sectors. There is a need to ensure energy security, upgrade infrastructure, and expedite the long-delayed spectrum auctions to facilitate the digital transition. These reforms will allow entrepreneurs to set up businesses and create jobs, thereby addressing the growing unemployment issue, especially for the youth.

- **Reduce the existing regulatory barriers to private investment.** Red tape and burdensome bureaucratic procedures should be streamlined to give better opportunities for businesses to start and innovate. The option of establishing a business should be open to all entrepreneurs on a level playing field. Localization and industrial policies should not be used as a blunt instrument to serve protectionist views and vested interests, which could hinder industrial development and harm competitiveness. It is also important to ensure consistency of localization and industrial policies with South Africa's international trade commitments.

- **Increase labor market flexibility to boost job opportunities and facilitate workforce management.** South Africa can benefit from an expanding labor force—something that many other countries cannot because of their demographics. Introducing greater firm-level flexibility in wage bargaining and streamlining the enforcement of employment protection legislation are necessary steps for this labor force to find the right jobs. Importantly, improving the quality of education and vocational training programs would allow the young population to acquire the skills demanded by employers.

- **Intensify actions to address weak governance and corruption.** Eradicating corruption will help channel talent, investment, and technology toward their best uses and foster public trust in government institutions. Strengthening the autonomy of anti-corruption agencies, enhancing criminal prosecution, establishing credible deterrence mechanisms, and increasing the transparency of beneficial ownership in procurement contracts are all essential steps.

The announced reforms to attract private-sector participation in energy generation and port and railway operations are encouraging but need to be supported by steadfast action to address Eskom's and Transnet's operational and financial problems. Importantly, governance weaknesses are a serious problem that continues to jeopardize the operations of both institutions.

- **Eskom.** The restructuring and unbundling of Eskom will be costly for the government and must be accompanied by a substantial downsizing and structural transformation of its operations, notably through a meaningful reduction of procurement and personnel costs. Eskom spends more than it earns, reflecting both its operational inefficiencies and unsustainable debt level. Competition from private firms is necessary. The resulting higher level of private investment should help finance the energy transition away from coal, contributing to climate change objectives. The unbundled subsidiaries should operate efficiently without resorting to budgetary funds and maintain sound governance and financial frameworks to guarantee their commercial viability.

- **Transnet.** Efforts to address the problems in logistics and infrastructure should be accelerated so that South Africa can fully benefit from favorable commodity prices and boost exports without the constraint of transportation deficiencies. Necessary actions include injecting greater discipline into the company's operations and fostering private sector participation in the port and railway sectors.

- **Other SOEs.** A full inventory of SOEs at all levels of government should be carried out. SOEs that do not meet their objectives or lack economic relevance should be divested or liquidated depending on commercial viability. SOEs carrying out predominantly government business should have their functions merged into a related government department or an agency under the purview of the budget.

Putting Debt on a Sustainable Path

Maximizing the growth dividend from structural reforms requires decisively reversing the upward trend in public debt. The last decade has demonstrated that increasing expenditure has not fostered durable growth because structural rigidities have impeded channeling spending to productive and competitive activities, Persistent budget deficits have saddled the government with a high debt burden and ballooning financing costs, while leaving no fiscal space to facilitate significant human capital and infrastructure investment. An ambitious fiscal consolidation is necessary to restore fiscal space and maximize the impact of structural reforms by welcoming private investment. A credible public debt anchor—defined as a government's goal not to surpass a pre-defined debt ceiling over time—would help complement the existing nominal primary expenditure ceiling in guiding consolidation and limiting debt accumulation when economic activity is set to remain persistently weak.

A growth-friendly fiscal consolidation needs to center on reducing current expenditure in real terms (so that any increases are lower than inflation) while broadening the tax base. Spending measures should tackle compensation costs, improve the efficiency of health and education expenditure, better target tertiary education subsidies, and strengthen the planning and execution of public investment, while protecting targeted support to the vulnerable. Importantly, there is an urgent need to condition any form of support to SOEs on the implementation of concrete and measurable actions, such as reductions in SOE's procurement and compensation costs, to significantly improve their performance and restore their viability. Performance against these conditions should ideally be transparently communicated to the public to instill confidence that the reforms are successfully ongoing. Phasing out carbon tax exemptions and tax incentives for selected industries will help boost tax revenue collections.

The Medium Term Budget Policy Statement (MTBPS) rightly outlines a consolidation path to unwind much of the pandemic-related support over time. Revenue projections are appropriately conservative, given the recent windfall and improved tax administration at the South African Revenue Service. Expenditure projections on two key budgetary items—compensation of employees and transfers to SOEs—reflect the National Treasury's intention to impose discipline but require a concerted effort from all parts of the government. Social transfers, while necessary to mitigate elevated poverty and inequality, should only target the most vulnerable population and fall within the available budgetary space. The credibility of the medium-term budget critically hinges on the government as a whole uniting behind the decisions underpinning the MTBPS's projections.

Should expenditure trends continue as in the past, spending would be larger than budgeted in the MTBPS and debt would be significantly higher than planned, hurting the availability and costs of financing, worsening the quality of spending, and crowding out private-sector credit. Postponing the necessary consolidation could force an abrupt adjustment with adverse growth and social consequences.

Maintaining Price Stability and Financial Sector Soundness

Accommodative monetary policy has helped mitigate the pandemic's impact, but looking ahead, the South African Reserve Bank (SARB) needs to remain vigilant about rising inflation risks by maintaining its data-dependent and forward-looking approach. The recent increase in the policy rate was appropriate and consistent with both the planned gradual withdrawal of monetary policy support and the SARB's commitment to price stability. External sector policies should remain consistent with the inflation-targeting framework by maintaining a flexible exchange rate.

South Africa's inflation remains above that of its main trading partners and other EMEs. Its citizens—particularly the poor—would benefit from lower inflation outturns and expectations. Thus, when circumstances allow in the future, the authorities are encouraged to lower the inflation target within a transparent and well-communicated strategy. Limiting the potential cost of disinflation would require that the process be supported by conducive fiscal and structural policies. A strong fiscal position would reduce inflation risks. More competitive and flexible product and labor markets would lead to lower production costs and inflation. Importantly, monetary policy has been effective in anchoring inflation but cannot contribute significantly to the growth objective, particularly if structural rigidities persist. The planned shift in the monetary policy implementation framework, currently under public consultation, should be focused on strengthening monetary policy transmission and the SARB's ability to support market functioning.

The financial sector has weathered the pandemic well. Robust prudential regulation—closely aligned with international standards—and a commitment to independent supervision has helped moderate risk. However, the financial system's resilience needs to be strengthened further amid the weak macroeconomic outlook and the government's large borrowing needs. This would allow banks to increase their role as intermediaries of funds for productive investments, including for small and medium-sized enterprises. The ongoing expansion of the payment system to nonbank financial institutions should also help deepen financial access and inclusion. Close monitoring of the deepening nexus between the financial sector and the sovereign is warranted, together with enhanced supervision, swift completion of the bank resolution and deposit insurance schemes, and improved implementation of anti-money laundering/combating the financing of terrorism measures. Reforms to the pension system need to be carefully designed to prevent undermining old-age security savings of the population and weakening one of the key pillars of the strong financial system.

Building A Green and Climate-Resilient Economy

South Africa faces significant climate challenges, reflecting both its high vulnerability to extreme weather events and the carbon intensity of the economy. The country's ambition to achieve carbon-neutrality by mid-century is commendable. Encouraging initial steps have been taken and have been well received by the international community as evidenced by the support at the COP26 climate summit. Nevertheless, stepped-up efforts are needed to translate the ambitious commitments into a coherent set of concrete actions that will benefit all South Africans, particularly the poorest, who tend to suffer the most from climate change. In particular, decarbonizing the energy sector while ensuring energy security will be essential. A swift rollout of renewable energy facilitated by a competitive energy market as well as a successful transformation of Eskom are key in this regard. Sound policies to safeguard macroeconomic stability, strengthen institutions, and advance reforms to make product and labor markets more dynamic will complement a just transition toward a green and climate resilient economy.

The IMF mission team thanks the South African authorities and all other interlocutors for the candid discussions.